

# Truth and Beauty...

## (and Russian Finance)

### *The Yukos Follies (continued):*

#### *Elections draw nigh, while the Empire regroups*

*Sitting in our Moscow office on the Kremlovskaya Naberezhnaya, as the leaves begin to fall from the trees we are enjoying an increasingly clear view of the Kremlin, just across the way. With Vladimir Putin currently out of Moscow, enjoying the Southern Hospitality of an oil-addicted US administration, back at home, the Duma election season has gotten underway in earnest. The importance of the outcome for the continuation of Putin's reform program should not be underestimated. For now, we are beginning to become concerned with some of the froth building up around the edges of Russian finance, but while we spend a goodly amount of our time wondering about what could possibly go wrong, we suspect that there may be a good 12-18 months of bull market in front of us. We take this opportunity to reflect on the current political direction of Russia, in particular as regards the influence of the oligarchs, and the likely contours of the future Duma.*

Over the summer, the great hurricane which swept across Russian capital markets following the arrest of Menatep's Lebedev gradually weakened to a minor tropical storm; currently it has faded to a drizzle. Yet – Lebedev remains in prison – while Khodorkovsky shows little sign of backing down. As Russia goes into the Duma campaigning season, the silence seems almost eerie.

Having remained quiet on this affair for most of the summer, President Putin recently restated a few simple facts: while there is absolutely no wholesale review of privatization under consideration, if criminal misconduct was involved in specific cases (the Federal Prosecutor's office is currently investigating allegations that Yukos – in its ugly former incarnation – may have been involved in the termination of an inconvenient mayor of Nefteyugansk with extreme prejudice) the law would be applied in all its rigor. While the necessity of punishing crimes of violence can hardly be argued, with due respects, an alternative interpretation is that a number of truly ugly stories are being held in reserve, just in case the Yukos/Menatep empire **still** doesn't take the hint!

Our initial explanation for the Yukos *scandale* (see T&B: The Yukos Follies, [www.sovlink.ru](http://www.sovlink.ru)) has, we think, been confirmed by events. Had the raid been part of a concerted attempt to weaken or even break up Yukos, the Sibneft merger would have never been subsequently approved. Although we are reliably informed that several members of Khodorkovsky's inner circle have precipitously taken up residence abroad, there have been no further strikes against Russia's premiere oil company – the fire has been concentrated on the financial holdings. Furthermore, the panicked fear of an assault upon the overall results of privatization proved utterly groundless; the remaining oligarchs continue to graze peacefully – fortunately for all involved, they are proving disinclined to be seen in public with political parties. Thus, we believe that the raid was quite simply President Putin's way of enforcing the historic compromise of 2000: the oligarchs are welcome to enrich themselves, but God help he among the Boyars who thinks to overshadow the Tsar!

That Putin himself was involved in this strategy should be obvious; the story circulated by Yukos PR hacks claiming that the siloviki had launched this raid in total darkness was self-serving nonsense! As we noted at the time, had the latter group been motivated by a desire to grab what it perceived to be its fair share of the privatization spoils, they would have begun their attack by targeting anyone but Yukos – the strongest, best-protected and most dangerous of the new oligarchic groups. No, we think it clear that, in the run-up to the Duma elections, Vladimir Putin intended to issue a stern warning to the oligarchs to stay out of politics by taking out the bull-elephant of the herd, Mikhail Khodorkovsky.

### ***ANOTHER (SELF-APPOINTED) RUSSIAN RESISTANCE HERO...***

Khodorkovsky's claim to be fighting for Russian liberties seems transparently absurd, reminiscent of similar claims by the truly nefarious and half-mad Boris Berezovsky. The fact that Yukos is publicly funding both the profoundly reactionary Russian Communist Party and Yavlinsky's ineffectual, right-wing Yabloko, suggests that ideology is not their first consideration. Although we believe that attempts by Yukos to gain economic ascendancy over Gazprom and Rosneft have been potent irritants to the Presidential administration, the raid on Menatep was obviously triggered by political imperatives: allowed to proceed unimpeded, Yukos-Menatep would likely have succeeded in "privatizing" a substantial chunk of the next Duma, i.e. buying a block of deputies sufficiently large to allow Khodorkovsky to negotiate with the President on an equal-to-equal basis. By beheading Khodorkovsky's closest protégé and impaling the head on a stake for all to see, Putin demonstrated the oligarch's inability to protect his closest associates – giving pause to any who might otherwise have offered themselves as vassals to Yukos' increasingly powerful lord.

Although this highly selective employment of the machinery of justice is not a particularly edifying spectacle – given the raw power of the oligarchic groups, both logistical (they still maintain small private armies and extensive security services) and especially, financial – it can be argued that Putin is compelled to use the weapons at his disposal. It is admittedly crude, but equally, it should be obvious that – before Russia can have any chance of evolving into a Western-style law-based society - the powerful barons must see their power sharply curtailed.

### ***OIL SPILLS***

While the major factor in triggering the raid was Menatep's take-over bid for the Duma, Yukos' pressure and encroachment upon Rosneft, Transneft and Gazprom were probably not completely alien to it. While more attention has been given to the issue of Yukos' designs upon the Gazprom monopoly, the most important issue may have been Khodorkovsky's aggressive push to be allowed to export as much crude as Yukos can possibly pump, irrespective of the consequences for the oil market. Indeed, when an oil price collapse threatened in 2000, it was cooperation by Russia and Norway with OPEC which allowed a compromise to be reached. At the time, Khodorkovsky lobbied furiously against these (modest and temporary) export limitations. OPEC has signaled that its most recent 3% cut in oil production was its last without cooperation from non-OPEC producers; subsequently, free riders would be punished with a price collapse. Like in the 1997 fight between Saudi and Venezuela, the threat is deadly serious. Were Khodorkovsky allowed to build private pipelines, the Russian government would effectively lose all influence upon export volumes and would thus have no effective means of supporting OPEC. This could lead to a showdown with deeply unpleasant short-term consequences for Russia's current account and budget surpluses.

## **YUKOS : BABYLON OR JERUSALEM?**

During a recent meeting with T&B, a senior and long-serving Menatep figure sought to extract from us at least the admission that there were some good things about Yukos – the man was preaching to the choir! The transformation of Yukos from a particularly ugly duckling into the magnificent (if somewhat oily) Swan of the Russian market has been the single most powerful argument used by ourselves and many of our colleagues seeking to convince Western audiences of the root-and-branch transformation of Russian business. Enthusiastically embracing Western corporate best practices, as an oil company, Yukos has set a new standard for Russia: its reservoir management and exploration teams are excellent, while its management has shown great strategic flair. Indeed, in a previous incarnation, the present author was the first Western analyst to rate Yukos a “buy” – this at a time when it was universally feared and loathed by the analyst community, still delisted from the RTS, and trading at about 50 cents; even by the standards of our beloved Russian market, a 3,000% upside is not to be sneezed at!

Perhaps one of the problems lies in perception. There is a Western tendency to anthropomorphize economic entities, attributing to them the qualities of good and evil; they are, of course, neither one nor the other. Rather – as suggested by the recent spate of US corporate governance scandals – like biological organisms, companies strive to maximize their success under a merciless regime of natural selection. Successful economic operators rapidly adapt to their circumstances: in the late 90’s, given the obviously unsustainable nature of the entire Russian politico-economic edifice, the only rational approach was to grab assets by whatever means possible, squeezing the cash out of Soviet remnants and stashing it safely abroad. That has now changed.

With the rise of Vladimir Putin in the aftermath of the August crisis, a radically new phase in Russian capitalism began. Khodorkovsky’s great merit was his having been among the first to understand the nature of the post-crisis transformation: by adopting international standards of corporate governance and transparency, he increased the value of his assets by nearly one hundred-fold trough-to-peak. His excellent example has been adopted by an increasing number of Russian entrepreneurs, as one after another, companies such as Norilsk Nickel have begun to sing in the angelic, born-again corporate governance choir. We think it most unfortunate that Mr. Khodorkovsky, having contributed so greatly to the economic recovery, cannot now refrain from getting involved in politics. Power is reputedly more addictive than heroin, and like it, requires ever-increasing doses... as the increasingly pathetic antics of Berezovsky have demonstrated, the withdrawal phase tends to be terribly disagreeable.

## **DUMA ELECTIONS – BACK AT THE CROSS-ROADS**

*As noted by the Austrian polemist Karl Kraus<sup>1</sup>, abuse of language in the framing of the political debate leads to falsification of the conclusions. Anyone doubting this assertion would do well to observe the political debate in post-war France where the agglomeration of the terms “justice” and “equality” conveniently glosses over their fundamental incompatibility – at least in the extreme form: (ineluctably, total indulgence of one would sharply curtail the other!) Another example is the convenient redefinition of the term “Democracy” by successive US administrations as meaning “whatever happens to favor US interests”; this leads to a profound incomprehension of the motivation behind other countries’ political choices. Similarly, there is a tendency to judge the current Russian political context using a vocabulary borrowed from post-war Europe, which is, of course, living in a phase of development very different from that of modern Russia...*

It is poorly understood in the West that, desperately in need of further reform, in many ways Russia actually benefits from the absence of a developed system of checks and balances. Consider for a moment the seemingly insurmountable obstacles facing pension reform in Europe; entrenched interest groups and potent lobbies force a never-ending series of compromises - at the risk of emasculating obviously vital legislation. In contrast, given the absence of powerful trade unions or of a serious political opposition, Russia recently

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<sup>1</sup> The author’s great uncle. A philosopher, journalist, polemicist, satirist and semanticist who single-handedly edited the journal Die Fackel, covering several decades of life in one of the most intellectually fecund periods of modern history, early 20<sup>th</sup> Century Vienna.

enacted far-reaching (though, admittedly, very imperfect) reform of the pensions system with little if any opposition; no serious financial interests were compromised by this particular reform. Alas, one of the banes of the US political system – the overwhelming lobbying power of business interests and the corruption it brings (whether in the form of cash-in-pocket or of campaign contributions) – is increasingly becoming a serious impediment to the passage of further reform legislation in the Russian Duma.

As was pointed out by our old friend Bernie Sucher, currently building Russia's first world-class asset management business at Alfa Capital, half-way through his expected second term, Vladimir Putin will become essentially a lame duck president. Thus, to secure his place in history as the man who finally turned Russia around, he must act quickly, enacting further root-and-branch reform. The pace of such reform, impressive early in his presidency, is infuriatingly now being slowed by intensive Duma lobbying – and by outright corruption – on the part of powerful economic interest groups. Mr. Putin is counting on the next Duma to be more proactive.

We will not here embark upon a thoroughgoing, and necessarily tedious, review of the current physiognomy of Russian political parties. Simply put, unlike the situation going into the elections of 1995 and (in theory) 1999, with the demise of the communist party's presidential ambitions, there is no further threat of a substantial change in the politico-economic model. Instead, the Kremlin is struggling to build a coherent majority against the centrifugal pull of a number of small special interest parties. Although the opinion polls have not been particularly encouraging, two specificities of the Russian electoral system must be borne in mind. The first is that 50% of the Duma seats are filled by an odd system of single-mandate constituencies. While half the Duma is elected in a European-style first-past-the pole system as a function of their proportional share among all parties receiving more than 5% of the total vote, the other half is elected directly in a two-round ballot in each constituency. These latter deputies tend to be without strong political party ties, and are generally far closer to the regional administrations. Thus, the election actually ends several months after the last votes are cast, following what amounts to an open-outcry auction for deputies by the major parties. It was the massive migration of these single-mandate deputies from Luzhkov's Fatherland to Putin's Unity Party after the 1999 election which led to the relative political eclipse of the Moscow mayor. It is also upon this "floating electorate" that the oligarchs, in particular Yukos/Menatep, have based their hopes of increasing their representation in the Duma.

The contenders:

-Unity. Profoundly uninspiring as a political party, Unity will benefit from strong and increasingly overt support from President Putin. Although its performance in the polls may disappoint, it will do well in the "auction" for single mandate deputies.

-KPRF. Despite seeing its declining electorate being nibbled away at the edges by left reformist parties, the Communist party remains relatively monolithic, and will clearly serve the role of opposition in the next Duma; this is fortunate since it is essentially unelectable!

-Luzhkov/Shaimiev's Fatherland Party, the intended successor to Chernomyrdin's Our Home is Russia (until Putin pulled out the rug from under them) is suffering from the lack of sufficient political patronage, and will be happy to retain a substantial block of deputies, assembled from amongst the single-mandate candidates.

-Zhirinovskiy's LDPR has seen something of a rebound. While Zhirinovskiy's presence in the Duma rather than in a mental institution (or a home for retired actors) says little good about the state of the Russian body politic, LDPR can be relied upon to continue to back the party of power, in return for a very modest consideration...

-SPS and Yabloko. The only real suspense is which of the liberal parties, Yavlinsky's ineffectual and obstructive Yabloko or Chubais' garner - SPS, will cross the 5% hurdle required for representation in the Duma. Theoretically, they could poll up to a total of 9.9% without gaining any representation. At present, polls suggest that both will squeak through.

In brief, the question is not whether Putin will command a working majority in the next Duma, but what the nature of this majority will be, i.e. will it be an obstructive, slow-moving chamber upon which the Kremlin will need to lavish constant attention, patronage, and money in competition with well-funded special interest groups, or will it be an active partner in completing the impressive and thoroughgoing restructuring initiated by Vladimir Putin in 2000. Certainly, if the attacks by the oligarchs can be successfully fended off, Putin's managed democracy may well result in a Duma comprised of Putin "mini-me's". While it may sound a trifle cynical, this outcome would be massively positive in terms of Russian reform.

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